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SUBJECT: Poland's Stabilization Pact - What it means for the Economy

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SUMMARY AND INTRODUCTION

¶1. (SBU) On February 2, the ruling conservative Law and Justice (PiS) party signed a stabilization pact with two opposition parties - Self Defense (SO) and the League of Polish Families (LPR). The pact includes a list of bills the parties agree to support, and a shorter list of those they will discuss. Details of bills related to the economy are sketchy, with most no more than general goal statements. Some of the proposed bills are pro-business, but others reflect the new government's desire to increase control of the economy and expand the social safety network. At a minimum, the bills convey the impression that the GOP will not place initial priority on serious tax reform or cuts in public spending.

What is in the Pact?

¶2. (U) In agreeing to the stabilization pact, PiS, LPR and SO agreed to support a package of approximately 144 bills in 2006, and to send another more controversial group of 15 bills, mostly developed by SO, to a working group composed of representatives of the three parties for consultation. This smaller set of controversial bills would be submitted to the Sejm only after consultation and agreement by the parties. This cable will concentrate on the economic bills included in the pact.

¶3. (U) The majority of the economic bills listed contain only a few words stating the bill's general intent. The pact says little about the specific content of draft legislation. As a result, local analysts must look to draft bills written by PiS, SO, and LPR during the previous session of the Sejm for clues to the likely intent of the legislation.

¶4. (U) The Stabilization pact originally included three appendices listing draft laws. The first appendix includes a listing of the bills the three parties agree to support. The second appendix includes the 15 controversial bills that will be referred to a joint working group for analysis. The third appendix lists other agreements reached by the parties. Our analysis is based on the limited information on the bills available at this time and discussions with individuals familiar with PiS, LPR, and SO legislative priorities.

¶5. (SBU) The proposed bills from Appendix One (those that will be voted on by the Sejm and supported by the three parties) that could impact the economy can be divided into four groups: (1) bills that will further liberalize the economy or remove bureaucratic obstacles faced by investors; (2) bills that are expected to negatively impact the Polish economy or U.S. business interests; (3) bills with the potential to adversely affect Poland's economy depending on how they are written; (4) and bills that do not directly relate to the economy, but may have economic consequences.

First - The Positives

¶6. (SBU) A number of bills are likely to have a positive effect on Poland's economy when passed. These include:

- A law to simplify procedures for establishing a company;

- Tax breaks for entrepreneurs undertaking innovative projects;

- Legislation to allow supplementary voluntary insurance for health care;

- Streamlined European patent issuance;

- Promotion of investment in Poland and of Polish companies abroad;

- An amendment to the energy law that will bring it into line with the EU on cogeneration and natural gas supply;

- A proposal to introduce transparent procedures for appointing members of supervisory boards;
- The establishment of a "basket" of health care services to receive guaranteed public funding, an act which will finally demarcate the financial borders of the current open-ended public system.

Next - The Negatives

¶7. (SBU) Local economic analysts expect the following bills to have negative impact on Poland's business climate or fiscal situation. These include:

- A draft bill on "Supply Agreements for State Defense and Security" which "aims to ensure the more effective harnessing of offset agreements for the country's economic development". Depending upon the final wording, this bill could place a greater burden on foreign defense firms to make broad "off-set" trade and investment deals in order to win a Polish defense tender;

- A bill requiring the replacement of the separate supervisory bodies currently regulating banks institutions, insurance companies, investment funds, and pension funds by a single watchdog agency -- the Financial Supervision Office (UNF). The UNF would absorb the Securities Commission, the Insurance and Pension Fund Supervision Office, and starting in January 2008, the Banking Supervision Commission. The proposed UNF chief
(tipped to be Finance Ministry Under Secretary Cezary Mech) will report directly to the prime minister and have broad authority, including the right to submit legislative proposals directly to the prime minister and to conduct criminal investigations. (Comment: Many observers fear that this would lead to a decrease in regulatory autonomy and increased politicization of these key sectors. End Comment.);

- A bill to providing fuel excise tax refunds to farmers;

- A bill to expand unemployment benefits for those unable to find work; and

- The indexation of pensions to inflation and wage increases. (Note: Preliminary estimates are that this provision alone will cost over 3 billion zloty or around US $1 billion. End note.).

Then - Positives or Negatives?

¶8. (SBU) There is a large group of bills about which we don't have enough information to determine whether they will have a negative or positive effect on the economy including:

- A proposed change to the Central Bank (NBP) charter obliging it - like the US Federal Reserve - to consider economic growth as well as inflation in its decision-making; (Comment: This bill could limit the NBP's independence - a goal of both PiS and SO. Przemyslaw Gosiewski, Chairman of the PiS parliamentary caucus, recently stated that the number of Monetary Policy Council (MPC) members also remains an open issue. Dissolution of the MPC is not likely as it is a constitutional body. End Comment.)

- An amendment to the law on public tenders which would bring Polish regulations in line with EU laws and liberalize procedures. The proposal would raise the contract threshold above which a public tender is mandatory from 6,000 to 60,000 Euros. The contracting authorities will only be obliged to draw up contract regulations ensuring fair competition and equal treatment of bidders. Critics fear that this new law could invite increased political interference and corruption.

- Tax reform remains a huge question. The pact only mentions six tax laws that will be amended. PiS originally promised a draft tax reform package at the end of January 2006, which has been delayed until March. Signals from the Ministry of Finance the need to pay for new social programs such as the one-off payments for child-bearing will preclude

tax cuts. Amendments to the VAT Act are also promised and these may include simplifications the Ministry of Finance previously has been reluctant to accept. The proposed law on inheritance and gift taxes will reportedly eliminate the taxation of assets inherited within a nuclear family. Solid taxpayers (e.g., state-owned enterprises that have been operating for a specific time and are not expected to unexpectedly shut down) would reportedly receive extra tax privileges;

- A provision to lengthen maternity leaves;

- A proposal to turn-over the supervision of State-owned companies to gminas (the lowest level of territorial administration in Poland).

The Unknown Impact of Non-Economic Bills

¶9. (U) These bills are the hardest to quantify as, with most of the other bills, details are still unknown. However, bills that may affect Poland's economic and financial picture although not strictly financial bills include:

- A draft bill creating a Central Anti-Corruption Office, which includes provisions for disclosure of discrepancies in operations of institutions receiving public funding;

- A draft bill on State security requiring the secret services to submit reports to the government and Sejm on economic and energy security, as well as an assessment of privatization deals from an economic security perspective.

The 15 items to be discussed at a later date

¶10. (U) The GOP has released no details of the 15 bills to be discussed by the working group other than names of draft laws included in the agreement. Many appear to be laws that Samobrona (SO) previously introduced in the Sejm during the election campaign. Most would increase government control of the economy or expand the social safety net, thus increasing the fiscal deficit - if passed in a similar form. (Note: Some observers think these bills are unlikely to be passed any time soon and that they have been included as a face-saving gesture for the LPR and SO supporters of these populist measures. They include:

- A law to establish a turnover tax on all businesses;

- A law on developing a system of benefits for the unemployed;

- A law to establish additional benefits for the poorest pensioners;

- A law on large-sized retail centers (note: we believe this would attempt to limit hypermarket development. End note.);

- Laws to provide additional pension benefits to local administration heads and veterans;

- A law that would provide incentives to farmers to produce and use bio-fuels.

Comment - A Costly Puzzle

¶11. (SBU) The Stability Pact has been described as a hodgepodge of ideas cobbled together to satisfy various eclectic constituencies. Neither PiS nor the Ministry of Finance has been able to quantify the fiscal impact of the bills. Many of the bills, if implemented, will boost social spending, but do little to increase revenues or cut outlays in other areas. Thus it is unclear how these ideas would be financed. For example, the proposed new unemployment benefit alone could cost more than current GOP expenditures on national defense and public security, and only slightly less than spending on healthcare.

¶12. (SBU) Business is disappointed that the majority of initiatives seem to strengthen the state's role in the economy and support rural development, rather than focusing on tax cuts and structural reform. Local economists generally agree that the bills are at best unclear in their effects and at worst might increase the fiscal deficit and throw sand in the economic gears. Post believes that the stabilization pact's economic legislation represents further fiscal drift, rather than reform. At a minimum, the bills appear to indicate that the GOP is not considering at this time serious tax reform or cuts in public spending. In the

final analysis, the devil will be in the details. However, the preliminary impression which has been created is that the GOP intends to expand the scope for administrative interventions in the economy and increase Poland's already excessive rate of social welfare spending.

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